

TRAVELZOO INC

FORM 10-Q (Quarterly Report)

Filed 11/14/2005 For Period Ending 9/30/2005

Address	590 MADISON AVENUE 21ST FLOOR NEW YORK, New York 10022
Telephone	212-521-4200
CIK	0001133311
Industry	Computer Services
Sector	Technology
Fiscal Year	12/31

Powered By **EDGAR**
Online

<http://www.edgar-online.com/>

© Copyright 2005. All Rights Reserved.

Distribution and use of this document restricted under EDGAR Online's Terms of Use.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2005

Or

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File No.: 000-50171

TRAVELZOO INC.

(Exact name of registrant as specified in its charter)

DELAWARE

*(State or other jurisdiction of
incorporation or organization)*

**590 Madison Avenue, 21st Floor,
New York, New York**

(Address of principal executive offices)

36-4415727

*(I.R.S. Employer
Identification No.)*

10022

(Zip Code)

Registrant's telephone number, including area code: **(212) 521-4200**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

As of November 11, 2005, the registrant had outstanding 16,250,479 shares of its \$0.01 par value common stock.

TRAVELZOO INC.

Table of Contents

	<u>Page</u>
PART I—FINANCIAL INFORMATION	
Item 1. Unaudited Condensed Consolidated Financial Statements	3
Condensed Consolidated Balance Sheets as of September 30, 2005 and December 31, 2004	3
Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2005 and 2004	4
Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2005 and 2004	5
Notes to Condensed Consolidated Financial Statements	6
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3. Quantitative and Qualitative Disclosures About Market Risk	26
Item 4. Controls and Procedures	26
PART II—OTHER INFORMATION	
Item 6. Exhibits	27
Signatures	28
Certification of CEO and CFO Pursuant to Rule 13a-14(a) and Rule 15d-14(a)	
Certification of CEO and CFO Pursuant to Section 906	

PART I—FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

TRAVELZOO INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	<u>September 30,</u> <u>2005</u>	<u>December 31,</u> <u>2004</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$22,734,903	\$26,434,989
Short term investments	19,918,000	10,031,738
Accounts receivable, less allowance for doubtful accounts of \$206,712 and \$127,547 as of September 30, 2005 and December 31, 2004, respectively	8,289,900	5,327,279
Deposits	123,215	163,130
Prepaid expenses and other current assets	375,811	674,208
Deferred income taxes	370,559	390,895
Total current assets	<u>51,812,388</u>	<u>43,022,239</u>
Deposits, less current portion	91,401	—
Deferred income taxes	43,237	43,237
Property and equipment, net	147,497	108,399
Intangible assets, net	34,034	83,563
Total assets	<u>\$52,128,557</u>	<u>\$43,257,438</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 700,835	\$ 439,425
Accrued expenses	3,649,336	2,464,269
Deferred revenue	311,508	91,137
Income tax payable	619,090	—
Total liabilities	<u>5,280,769</u>	<u>2,994,831</u>
Commitments and contingencies		
Stockholders' equity:		
Common stock	162,505	162,332
Additional paid-in capital	30,606,705	30,299,991
Accumulated other comprehensive income	(30,357)	—
Retained earnings	16,108,935	9,800,284
Total stockholders' equity	<u>46,847,788</u>	<u>40,262,607</u>
Total liabilities and stockholders' equity	<u>\$52,128,557</u>	<u>\$43,257,438</u>

See accompanying notes to unaudited condensed consolidated financial statements.

TRAVELZOO INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenues	\$13,384,340	\$ 9,507,188	\$36,870,898	\$23,170,610
Cost of revenues	225,275	183,542	628,867	528,977
Gross profit	<u>13,159,065</u>	<u>9,323,646</u>	<u>36,242,031</u>	<u>22,641,633</u>
Operating expenses:				
Sales and marketing	7,101,026	4,338,518	18,282,597	11,462,392
General and administrative	1,878,494	1,657,152	6,613,814	3,873,254
Total operating expenses	<u>8,979,520</u>	<u>5,995,670</u>	<u>24,896,411</u>	<u>15,335,646</u>
Income from operations	4,179,545	3,327,976	11,345,620	7,305,987
Other income and expense:				
Interest income	278,600	9,090	656,333	20,868
Foreign currency gain (loss)	<u>(4,117)</u>	<u>—</u>	<u>(8,238)</u>	<u>—</u>
Income before income taxes	4,454,028	3,337,066	11,993,715	7,326,855
Income taxes	<u>2,155,790</u>	<u>1,371,250</u>	<u>5,685,065</u>	<u>3,018,042</u>
Net income	<u>\$ 2,298,238</u>	<u>\$ 1,965,816</u>	<u>\$ 6,308,650</u>	<u>\$ 4,308,813</u>
Basic net income per share	\$ 0.14	\$ 0.13	\$ 0.39	\$ 0.25
Diluted net income per share	\$ 0.13	\$ 0.11	\$ 0.35	\$ 0.23
Shares used in computing basic net income per share	16,250,479	15,488,204	16,248,688	17,111,490
Shares used in computing diluted net income per share	17,695,044	17,292,962	17,897,288	18,561,924

See accompanying notes to unaudited condensed consolidated financial statements.

TRAVELZOO INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30,	
	2005	2004
Cash flows from operating activities:		
Net income	\$ 6,308,650	\$ 4,308,813
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	126,270	120,686
Deferred income taxes	20,336	—
Provision for losses on accounts receivable	79,364	111,519
Tax benefit of stock option exercises	396,067	943,110
Accrued interest income from short-term investments	(268,109)	—
Changes in operating assets and liabilities:		
Accounts receivable	(3,049,883)	(2,586,547)
Deposits	(52,007)	(22,307)
Prepaid expenses and other current assets	296,373	(154,332)
Accounts payable	266,415	84,256
Accrued expenses	1,187,506	410,867
Deferred revenue	220,420	154,580
Income tax payable	619,090	(1,105,773)
Net cash provided by (used in) operating activities	<u>6,150,492</u>	<u>2,264,872</u>
Cash flows from investing activities:		
Purchases of property and equipment	(116,892)	(38,908)
Purchase of short-term investments	(29,691,479)	—
Sale of short-term investments	20,073,326	—
Net cash used in investing activities	<u>(9,735,045)</u>	<u>(38,908)</u>
Cash flows from financing activities:		
Issuance costs incurred in connection with 2004 issuance of common stock	(123,732)	—
Proceeds from stock option exercises	34,550	295,767
Recovery of profit from purchase and sale of stock by employees	—	34,390
Net cash used in financing activities	<u>(89,182)</u>	<u>330,157</u>
Effect of exchange rate on cash and cash equivalents	(26,351)	—
Net increase (decrease) in cash and cash equivalents	(3,700,086)	2,556,121
Cash and cash equivalents at beginning of period	26,434,989	3,521,637
Cash and cash equivalents at end of period	<u>\$ 22,734,903</u>	<u>\$ 6,077,758</u>
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	<u>\$ 4,649,572</u>	<u>\$ 3,180,705</u>

See accompanying notes to unaudited condensed consolidated financial statements.

TRAVELZOO INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1: The Company and Basis of Presentation

Travelzoo Inc. (the “Company” or “Travelzoo”) is an Internet media company. The Company’s publications include the *Travelzoo* Web sites (www.travelzoo.com and www.travelzoo.co.uk), the *Travelzoo Top 20* e-mail newsletter, and the *Newsflash* e-mail product. The Company also operates *SuperSearch*, a pay-per-click travel search engine.

Travelzoo is controlled by Ralph Bartel, who held approximately 78% of the outstanding shares as of November 1, 2005.

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosure normally included in consolidated financial statements prepared in accordance with Generally Accepted Accounting Principles in the United States of America have been condensed or omitted in accordance with such rules and regulations. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position of the Company, and its results of operations and cash flows. These condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and related notes as of and for the year ended December 31, 2004, included in the Company’s Form 10-K filed with the SEC on March 31, 2005.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

The results of operations for the nine months ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005 or any other future period, and the Company makes no representations related thereto.

The Company was formed as a result of a combination and merger of entities founded by the Company’s majority stockholder, Ralph Bartel. In 1998, Mr. Bartel founded Travelzoo.com Corporation, a Bahamas corporation, which issued 5,155,874 shares via the Internet to approximately 700,000 “Netsurfer stockholders” for no cash consideration. In 1998, Mr. Bartel also founded Silicon Channels Corporation, a California corporation, to operate the *Travelzoo* Web site. During 2001, Travelzoo Inc. was formed as a subsidiary of Travelzoo.com Corporation, and Mr. Bartel contributed all of the outstanding shares of Silicon Channels to Travelzoo Inc. in exchange for 8,129,273 shares of Travelzoo Inc. and options to acquire an additional 2,158,349 shares at \$1.00. The merger was accounted for as a combination of entities under common control using “as-if pooling-of-interests” accounting. Under this method of accounting, the assets and liabilities of Silicon Channels Corporation and Travelzoo Inc. were carried forward to the combined company at their historical costs. In addition, all prior period financial statements of Travelzoo Inc. were restated to include the combined results of operations, financial position and cash flows of Silicon Channels Corporation.

During January 2001, the Board of Directors of Travelzoo.com Corporation proposed that Travelzoo.com Corporation be merged with Travelzoo Inc. whereby Travelzoo Inc. would be the surviving entity. On March 15, 2002, the stockholders of Travelzoo.com Corporation approved the merger with Travelzoo Inc. On April 25, 2002, the certificate of merger was filed in Delaware upon which the merger became effective and Travelzoo.com Corporation ceased to exist. Each outstanding share of common stock of Travelzoo.com Corporation was converted into the right to receive one share of common stock of Travelzoo Inc. Under and subject to the terms of the merger agreement, stockholders were allowed a period of two years following the effective date of the merger to receive shares of Travelzoo Inc. The records of Travelzoo.com Corporation showed that, assuming all of the shares applied for by the Netsurfer stockholders were validly issued, there were 11,295,874 shares of Travelzoo.com Corporation outstanding. As of April 25, 2004, two years following the effective date of the merger, 7,180,342 shares of Travelzoo.com Corporation had been exchanged for shares of Travelzoo Inc. Prior to that date, the remaining shares which were available for issuance pursuant to the merger agreement were included in the issued and outstanding common stock of Travelzoo Inc. and included in the calculation of basic and diluted earnings per share. After April 25, 2004, the Company ceased issuing shares to the former stockholders of Travelzoo.com Corporation, and no additional shares are reserved for issuance to any former stockholders, because their right to receive shares has now expired. On April 25, 2004, the number of shares reported as outstanding was reduced from 19,425,147 to 15,309,615 to reflect

Table of Contents

actual shares issued as of the expiration date. Earnings per share calculations reflect the reduction of the number of shares reported as outstanding. As of September 30, 2005, there were 16,250,479 shares of common stock outstanding.

It is possible that claims may be asserted against the Company in the future by former stockholders of Travelzoo.com Corporation seeking to receive shares in the Company, whether based on a claim that the two-year deadline for exchanging their shares was unenforceable or otherwise. In addition, one or more jurisdictions, including the Bahamas or the State of Delaware, may assert rights to unclaimed shares of the Company under escheat statutes. If such escheat claims are asserted, the Company intends to challenge the applicability of escheat rights, in that, among other reasons, the identity, residency and eligibility of the holders in question cannot be determined. There were certain conditions applicable to the issuance of shares to the Netsurfer stockholders, including requirements that (i) they be at least 18 years of age, (ii) they be residents of the U.S. or Canada and (iii) they not apply for shares more than once. The Netsurfer stockholders were required to confirm their compliance with these conditions, and were advised that failure to comply could result in cancellation of their shares in Travelzoo.com Corporation. Travelzoo.com Corporation was not able to verify that the applicants met the requirements referred to above at the time of their applications for issuance of shares. If claims are asserted by persons claiming to be former stockholders of Travelzoo.com Corporation, the Company intends to assert that their rights to receive their shares expired two years following the effective date of the merger, as provided in the merger agreement. The Company also expects to take the position, if escheat or similar claims are asserted in respect of the unissued shares in the future, that it is not required to issue such shares. Further, even if it were established that unissued shares were subject to escheat claims, the Company would assert that the claimant must establish that the original Netsurfer stockholders complied with the conditions to issuance of their shares. The Company is not able to predict the outcome of any future claims which might be asserted relating to the unissued shares. If such claims were asserted, and were fully successful, that could result in the Company's being required to issue up to an additional approximately 4,080,000 shares of common stock for no additional payment.

On October 15, 2004, the Company announced a program under which it would make cash payments to persons who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests for shares in Travelzoo Inc. within the required time period. The accompanying consolidated financial statements include a charge in general and administrative expenses of \$61,000 for these cash payments for the three months ended September 30, 2005 and \$1,191,000 for the nine months ended September 30, 2005 of which \$6,000 remains as a liability as of September 30, 2005. The liability is based on the number of actual requests received from former stockholders through September 30, 2005 which had not yet been processed. The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received. The Company does not know how many of the requests for shares originally received by Travelzoo.com Corporation in 1998 were valid, but the Company believes that only a portion of such requests were valid. As noted above, in order to receive payment under the program, a person is required to establish that such person validly held shares in Travelzoo.com Corporation. Assuming 100% of the requests from 1998 were valid, former stockholders of Travelzoo.com Corporation holding an additional approximately 4,080,000 shares had not submitted claims under the program as of September 30, 2005.

The merger of Travelzoo.com Corporation into Travelzoo Inc. was accounted for as a combination of entities under common control using "as-if pooling-of-interests" accounting. Under this method of accounting, the assets and liabilities of Travelzoo.com Corporation and Travelzoo Inc. were carried forward at their historical costs. In addition, all prior period financial statements of Travelzoo Inc. were restated to include the combined results of operations, financial position and cash flows of Travelzoo.com Corporation. The restated results of operations and cash flows of Travelzoo Inc. are identical to the combined results of Travelzoo.com Corporation and Travelzoo Inc.

Note 2: Revenue Recognition

All revenue consists of advertising sales. Advertising revenues are principally derived from the sale of advertising in the U.S. on the *Travelzoo* Web site, in the *Travelzoo Top 20* e-mail newsletter, in *Newsflash*, and in *SuperSearch*. Revenues generated from the Company's operations in the U.K. were approximately \$368,000 and \$378,000 during the three months ended September 30, 2005 and the period from May 4, 2005 (inception) to September 30, 2005, respectively.

The Company recognizes revenues in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition*. Advertising revenues are recognized in the period in which the advertisement is displayed, provided that evidence of an arrangement exists, the fees are fixed or determinable and collection of the resulting receivable is reasonably assured. Where collectibility is not reasonably assured, the revenue will be recognized upon cash collection, provided that the other criteria for revenue recognition have been met. The Company recognizes revenue for fixed-fee advertising arrangements ratably over the term of

Table of Contents

the insertion order as described below. The majority of insertion orders have terms that begin and end in a quarterly reporting period. In the cases where at the end of a quarterly reporting period the term of an insertion order is not complete, the Company recognizes revenue for the period by pro-rating the total arrangement fee to revenue and deferred revenue based on a measure of proportionate performance of its obligation under the insertion order. The Company measures proportionate performance by the number of placements delivered and undelivered as of the reporting date. The Company uses prices stated on its internal rate card for measuring the value of delivered and undelivered placements. Fees for variable-fee advertising arrangements are recognized based on the number of impressions displayed or clicks delivered during the period.

Under these policies, no revenue is recognized unless persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collection is deemed reasonably assured. The Company evaluates each of these criteria as follows:

- *Evidence of an arrangement.* The Company considers an insertion order signed by the client or its agency to be evidence of an arrangement.
- *Delivery.* Delivery is considered to occur when the advertising has been displayed and, if applicable, the click-throughs have been delivered.
- *Fixed or determinable fee.* The Company considers the fee to be fixed or determinable if the fee is not subject to refund or adjustment and payment terms are standard.
- *Collection is deemed reasonably assured.* The Company conducts a credit review for all transactions at the time of the arrangement to determine the creditworthiness of the client. Collection is deemed reasonably assured if it is expected that the client will be able to pay amounts under the arrangement as payments become due. If it is determined that collection is not reasonably assured, then revenue is deferred and recognized upon cash collection. Collection is deemed not reasonably assured when a client is perceived to be in financial distress, which may be evidenced by weak industry conditions, a bankruptcy filing, or previously billed amounts that are past due.

The Company's standard payment terms are 30 days net. Insertion orders that include fixed-fee advertising are invoiced upon acceptance of the insertion order and on the first day of each month over the term of the insertion order, with the exception of *Travelzoo Top 20* or *Newsflash* listings, which are invoiced upon delivery. Insertion orders that include variable-fee advertising are invoiced at the end of the month. The Company's standard terms state that in the event that Travelzoo fails to publish advertisements as specified in the insertion order, the liability of Travelzoo to the client shall be limited to, at Travelzoo's sole discretion, a pro rata refund of the advertising fee, the placement of the advertisements at a later time in a comparable position, or the extension of the term of the insertion order until the advertising is fully delivered. The Company believes that no significant obligations exist after the full delivery of advertising.

Revenues from advertising sold to clients through agencies are reported at the net amount billed to the agency.

Note 3: Stock-based Compensation

The Company did not provide any stock-based compensation in fiscal years 2003 and 2004 or in the nine months ended September 30, 2005. In addition, all previously issued options vested prior to January 1, 2002. Accordingly, there would be no impact on net income due to the adoption of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, as amended, for the three or nine months ended September 30, 2005 or 2004.

Note 4: Net Income Per Share

Net income per share has been calculated in accordance with SFAS No. 128, *Earnings per Share*. Basic net income per share is computed by dividing the net income by the weighted-average number of reported common shares outstanding for the period. Diluted net income per share is computed by dividing net income by the weighted-average number of reported common shares and potential common shares outstanding during the period. Potential common shares included in the diluted calculation consists of incremental shares issuable upon the exercise of outstanding stock options calculated using the treasury stock method.

The following table sets forth the calculation of basic and diluted net income per share:

Table of Contents

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Basic net income per share:				
Net income	\$ 2,298,238	\$ 1,965,816	\$ 6,308,650	\$ 4,308,813
Weighted average common shares	16,250,479	15,488,204	16,248,688	17,111,490
Basic net income per share	\$ 0.14	\$ 0.13	\$ 0.39	\$ 0.25
Diluted net income per share:				
Net income	\$ 2,298,238	\$ 1,965,816	\$ 6,308,650	\$ 4,308,813
Weighted average common shares	16,250,479	15,448,204	16,248,688	17,111,490
Effect of dilutive securities: stock options	1,444,565	1,844,758	1,648,600	1,450,434
Diluted weighted average common shares	17,695,044	17,292,962	17,897,288	18,561,924
Diluted net income per share	\$ 0.13	\$ 0.11	\$ 0.35	\$ 0.23

Note 5: Commitments and Contingencies

The Company leases office space in Chicago, London (United Kingdom), Miami, Mountain View (California), and New York. These operating leases expire on December 31, 2007, April 30, 2007, December 31, 2006, December 31, 2007 and December 31, 2005, respectively. The future minimum rental payments under these operating leases as of September 30, 2005, and December 31, 2004 total \$1,328,000 and \$1,082,000, respectively. The future lease payments consist of \$308,000 of payments due in 2005, \$570,000 of payments due in 2006, and \$450,000 of payments due in 2007.

It is possible that claims may be asserted against the Company in the future by former stockholders of Travelzoo.com Corporation seeking to receive shares in the Company, whether based on a claim that the two-year deadline for exchanging their shares was unenforceable or otherwise. In addition, one or more jurisdictions, including the Bahamas or the State of Delaware, may assert rights to unclaimed shares of the Company under escheat statutes. If such escheat claims are asserted, the Company intends to challenge the applicability of escheat rights, in that, among other reasons, the identity, residency and eligibility of the holders in question cannot be determined. There were certain conditions applicable to the issuance of shares to the Netsurfer stockholders, including requirements that (i) they be at least 18 years of age, (ii) they be residents of the U.S. or Canada and (iii) they not apply for shares more than once. The Netsurfer stockholders were required to confirm their compliance with these conditions, and were advised that failure to comply could result in cancellation of their shares in Travelzoo.com Corporation. Travelzoo.com Corporation was not able to verify that the applicants met the requirements referred to above at the time of their applications for issuance of shares. If claims are asserted by persons claiming to be former stockholders of Travelzoo.com Corporation, the Company intends to assert that their rights to receive their shares expired two years following the effective date of the merger, as provided in the merger agreement. The Company also expects to take the position, if escheat or similar claims are asserted in respect of the unissued shares in the future, that it is not required to issue such shares. Further, even if it were established that unissued shares were subject to escheat claims, the Company would assert that the claimant must establish that the original Netsurfer stockholders complied with the conditions to issuance of their shares. The Company is not able to predict the outcome of any future claims which might be asserted relating to the unissued shares. If such claims were asserted, and were fully successful, that could result in the Company's being required to issue up to an additional approximately 4,080,000 shares of common stock for no additional payment.

On October 15, 2004, the Company announced a program under which it would make cash payments to persons who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests for shares in Travelzoo Inc. within the required time period. The accompanying consolidated financial statements included a charge in general and administrative expenses of \$61,000 for these cash payments for the three months ended September 30, 2005 and \$1,191,000 for the nine months ended September 30, 2005 of which \$6,000 remains as a liability as of September 30, 2005. The liability is based on the number of actual requests received from former stockholders through the reporting date which had not yet been processed. The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received. The Company does not know how many of the requests for shares originally received by Travelzoo.com Corporation in 1998 were valid, but the Company believes that only a portion of such requests were valid. As noted above, in order to receive payment under the program, a person is required to establish that such person validly held shares in Travelzoo.com Corporation. Assuming 100% of the requests from 1998 were valid, former stockholders of Travelzoo.com Corporation holding approximately 4,080,000 shares had not submitted claims under the program.

Table of Contents

Note 6: Significant Customer Information and Segment Reporting

SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information*, establishes standards for the reporting by business enterprises of information about operating segments, products and services, geographic areas, and major customers. The method for determining what information to report is based on the way that management organizes the operating segments within a company for making operational decisions and assessing performance. The Company has two operating segments: North America and Europe. North America consists of the Company's U.S. operations. Europe consists of the Company's U.K. operations. The Company began operations in the U.K. in May 2005. However, as of September 30, 2005, European operations and assets were not material, being less than 5% of revenues and assets, so detailed reporting has not been presented.

Significant customer information is as follows:

Customer	Percent of Revenues		Percent of Revenues		Percent of Accounts Receivable	
	Three Months Ended September 30,		Nine Months Ended September 30,		September 30,	December 31,
	2005	2004	2005	2004	2005	2004
A	12%	15%	16%	10%	13%	20%
B	*	*	*	*	13%	12%
C	*	10%	*	*	*	13%

All of the above customers are located in the U.S.

* Less than 10%

Note 7: Comprehensive Income

In accordance with SFAS 130, *Reporting Comprehensive Income*, the Company is required to display comprehensive income and loss and its components as part of the Company's consolidated financial statements. Accumulated other comprehensive income of \$30,000 for the nine months periods ended September 30, 2005 is comprised entirely of foreign currency translation adjustments recorded since the inception of Travelzoo (Europe) Ltd, formerly known as Travelzoo UK Ltd, in May 2005.

Note 8: Foreign Currency Translation

The functional currency of the Company's foreign subsidiary is deemed to be the local currency for the subsidiary. Current assets and current liabilities recorded in foreign currencies are translated into U.S. dollars at period-end exchange rates, and revenues and expenses are translated at average exchange rates during the period. The effects of foreign currency translation adjustments are included in other income (expense), net in the consolidated statements of operations. The effects of foreign currency translation adjustments are included in accumulated other comprehensive income (loss) within equity in the consolidated balance sheet. All transactional gains or losses on foreign currency transactions are recognized in other income (expense), net in the consolidated statement of operations.

Note 9: Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued SFAS 123R, *Share-Based Payment*, which requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in the statement of operations. The accounting provisions of SFAS 123R are effective for fiscal years beginning after June 15, 2005. The Company will adopt SFAS 123R on January 1, 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. As of September 30, 2005, the Company had no unvested stock-based compensation awards outstanding. Therefore, the Company does not expect the adoption of SFAS 123R to have a material effect on the Company's consolidated statement of operations. If, however, the Company grants stock options in future periods, these options would be valued pursuant to SFAS 123R and would result in stock compensation expense that could be material.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The information in this report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements are based upon current expectations, assumptions, estimates and projections about Travelzoo and our industry. These forward-looking statements are subject to the many risks and uncertainties that exist in our operations and business environment that may cause actual results, performance or achievements of Travelzoo to be different from those expected or anticipated in the forward-looking statements. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, words such as “may”, “will”, “should”, “estimates”, “predicts”, “potential”, “continue”, “strategy”, “believes”, “anticipates”, “plans”, “expects”, “intends”, and similar expressions are intended to identify forward-looking statements. Travelzoo’s actual results and the timing of certain events could differ significantly from those anticipated in such forward-looking statements. Factors that might cause or contribute to such a discrepancy include, but are not limited to, those discussed elsewhere in this Report in the section entitled “Risk Factors” and the risks discussed in our other Securities and Exchange Commission (“SEC”) filings. The forward-looking statements included in this report reflect the beliefs of our management on the date of this report. Travelzoo undertakes no obligation to update publicly any forward-looking statements.

Overview

Travelzoo Inc. (the “Company” or “Travelzoo”) is an Internet media company that publishes travel offers from hundreds of travel companies. As the Internet is becoming consumers’ preferred medium to search for travel offers, we provide airlines, hotels, cruise lines, vacation packagers, and other travel companies with a fast, flexible, and cost-effective way to reach millions of users. While our products provide advertising opportunities for travel companies, they also provide Internet users with a free source of information on current sales and specials from hundreds of travel companies.

Our publications include the *Travelzoo* Web sites (www.travelzoo.com and www.travelzoo.co.uk), the *Travelzoo Top 20* e-mail newsletter, and the *Newsflash* e-mail product. The Company also operates *SuperSearch*, a pay-per-click travel search engine. More than 300 travel companies purchase our advertising services.

We have two operating segments based on geographic regions: North America and Europe. North America consists of our U.S. operations. Europe consists of our U.K. operations which began in May 2005. As of September 30, 2005, European operations were less than 5% of revenues.

Our revenues are advertising revenues, consisting of listing fees paid by travel companies to advertise their offers on the *Travelzoo* Web sites, in the *Travelzoo Top 20* e-mail newsletter, in the *Newsflash* e-mail product, and in *SuperSearch*, a pay-per-click travel search engine. Revenues are principally generated from the sale of advertising on our *Travelzoo* Web site and in our *Travelzoo Top 20* newsletter. Listing fees are based on placement, number of listings, number of impressions, or number of clickthroughs. Smaller advertising agreements — typically \$4,000 or less per month — typically renew automatically each month if they are not terminated by the client. Larger agreements are typically related to advertising campaigns and are not automatically renewed.

When evaluating the financial condition and operating performance of the Company, management focuses on the following financial and non-financial indicators:

- Growth of number of subscribers of the Company’s newsletters and page views of the homepages of the *Travelzoo* Web sites;
- Growth in revenues in the absolute and relative to the growth in reach of the Company’s products;
- Operating margin;
- Revenue per employee as a measure of productivity.

Critical Accounting Policies

We believe that there are a number of accounting policies that are critical to understanding our historical and future performance, as these policies affect the reported amounts of revenue and the more significant areas involving management’s judgments and estimates. These significant accounting policies relate to revenue recognition, the allowance for doubtful accounts, and liabilities to former stockholders. These policies, and our procedures related to these policies, are described in detail below.

Revenue Recognition

We recognize revenue on arrangements in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition*. We recognize advertising revenues in the period in which the advertisement is displayed, provided that evidence of an arrangement exists, the fees are fixed or determinable and collection of the resulting receivable is reasonably assured. If fixed-fee advertising is displayed over a term greater than one month, revenues are recognized ratably over the period as described below. The majority of insertion orders have terms that begin and end in a quarterly reporting period. In the cases where at the end of a quarterly reporting period the term of an insertion order is not complete, the Company recognizes revenue for the period by pro-rating the total arrangement fee to revenue and deferred revenue based on a measure of proportionate performance of its obligation under the insertion order. The Company measures proportionate performance by the number of placements delivered and undelivered as of the reporting date. The Company uses prices stated on its internal rate card for measuring the value of delivered and undelivered placements. Fees for variable-fee advertising arrangements are recognized based on the number of impressions displayed or clicks delivered during the period.

Under these policies, no revenue is recognized unless persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collection is reasonably assured. The Company evaluates each of these criteria as follows:

- *Evidence of an arrangement.* We consider an insertion order signed by the client or its agency to be evidence of an arrangement.
- *Delivery.* Delivery is considered to occur when the advertising has been displayed and, if applicable, the clickthroughs have been delivered.
- *Fixed or determinable fee.* We consider the fee to be fixed or determinable if the fee is not subject to refund or adjustment and payment terms are standard.
- *Collection is reasonably assured.* We conduct a credit review for all transactions at the time of the arrangement to determine the creditworthiness of the client. Collection is deemed reasonably assured if we expect that the client will be able to pay amounts under the arrangement as payments become due. If we determine that collection is not reasonably assured, then we defer the revenue and recognize the revenue upon cash collection. Collection is deemed not reasonably assured when a client is perceived to be in financial distress, which may be evidenced by weak industry conditions, a bankruptcy filing, or previously billed amounts that are past due.

Advertising sold to clients through agencies is reported at the net amount billed to the agency.

Allowance for Doubtful Accounts

We record a provision for doubtful accounts based on our historical experience of write-offs and a detailed assessment of our accounts receivable and allowance for doubtful accounts. In estimating the provision for doubtful accounts, management considers the age of the accounts receivable, our historical write-offs, the creditworthiness of the client, the economic conditions of the client's industry, and general economic conditions, among other factors. Should any of these factors change, the estimates made by management will also change, which could impact the level of our future provision for doubtful accounts. Specifically, if the financial condition of our clients were to deteriorate, affecting their ability to make payments, additional provision for doubtful accounts may be required.

Liability to Former Stockholders

On October 15, 2004, we announced a program under which we would make cash payments to persons who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests for shares in Travelzoo Inc. within the required time period. We account for the cost of this program as an expense recorded in general and administrative expenses and a current accrued liability. The ultimate total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received. We do not know how many of the requests for shares originally received by Travelzoo.com Corporation in 1998 were valid. We believe that only a portion of such requests were valid. In order to receive payment under the program, a person is required to establish that such person validly held shares in Travelzoo.com Corporation.

Table of Contents

Since the total cost of the program is not reliably estimable, the amount of expense recorded in a period is equal to the number of actual claims received during the period multiplied by (i) the number of shares held by each individual former stockholder and (ii) the applicable settlement price based on the recent price of our common stock at the date the claim is received as stipulated by the program. Requests are generally paid within 30 days of receipt. Please refer to Note 5 to our unaudited condensed consolidated financial statements for further details about our liabilities to former stockholders.

Results of Operations

The following table sets forth, as a percentage of total revenues, the results of our operations for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenues	100%	100%	100%	100%
Cost of revenues	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>
Gross profit	<u>98</u>	<u>98</u>	<u>98</u>	<u>98</u>
Operating expenses:				
Sales and marketing	53	46	49	49
General and administrative	<u>14</u>	<u>17</u>	<u>18</u>	<u>17</u>
Total operating expenses	<u>67</u>	<u>63</u>	<u>67</u>	<u>66</u>
Income from operations	31	35	31	32
Other income and expenses, net	<u>2</u>	<u>—</u>	<u>2</u>	<u>—</u>
Income before income taxes	33	35	33	32
Income taxes	<u>16</u>	<u>14</u>	<u>16</u>	<u>13</u>
Net income	<u>17%</u>	<u>21%</u>	<u>17%</u>	<u>19%</u>

For the nine months ended September 30, 2005, we reported income from operations of approximately \$11.3 million. As of September 30, 2005, we had retained earnings of approximately \$16.1 million. Our operating margin decreased to 30.8% of sales for the nine months ended September 30, 2005 from 31.5% for the same period last year.

For the three months ended September 30, 2005, we reported income from operations of approximately \$4.2 million. Our operating margin decreased to 31.2% of sales for the three months ended September 30, 2005 from 35.0% for the same period last year. The main reason for this decrease in our operating margin is that our sales and marketing expenses grew faster than our revenues.

We do not know whether our marketing expenses as a percentage of revenue will continue to increase in future periods. Increased competition in our industry and increases in the average cost of acquiring a new subscriber (see "Subscriber Acquisition" below) could force us to further increase our marketing expenses as a percentage of revenue. Further, losses from our strategy to replicate our business model in selected foreign markets may have a material adverse impact on our results of operations.

The increase in other income from approximately \$9,000 in the three months ended September 30, 2004 to approximately \$279,000 in the three months ended September 30, 2005 represents interest earned on the Company's cash, cash equivalents, and short term investments.

Our losses from operations in the U.K. were approximately \$363,000 and \$538,000 for the three months ended September 30, 2005 and the period from May 4, 2005 (inception) to September 30, 2005, respectively, subject to any adjustments upon completion of a third-party transfer pricing analysis which is underway.

Reach

The following table sets forth the number of subscribers of each of our e-mail publications in both the U.S. and the U.K. as of September 30, 2005 and 2004 and the total number of page views for the homepage of the *Travelzoo* Web site in U.S. for the nine months ended September 30, 2005 and 2004. The Company does not have available information on the total number of page views for the homepage of the *Travelzoo* Web site in the U.K. Management considers the *Travelzoo* homepages as indicators for the growth in

Table of Contents

Web site traffic. Management reviews these non-financial metrics for two reasons: First, to monitor our progress in increasing the reach of our products. Second, to evaluate whether we are able to convert higher reach into higher revenues.

	September 30,		Year-over-Year Growth
	2005	2004	
Subscribers:			
North America			
<i>Travelzoo Top 20</i>	8,660,000	7,752,000	12%
<i>Newsflash</i>	5,780,000	5,237,000	10%
Europe			
<i>Travelzoo Top 20</i>	140,000	N/A	N/A
<i>Newsflash</i>	70,000	N/A	N/A

	Nine Months Ended September 30,		Year-over-Year Growth
	2005	2004	
Page views of homepages of <i>Travelzoo</i> Web sites:			
North America			
	29,888,000	22,670,000	32%
Europe			
	N/A	N/A	N/A

Management believes that the increase in reach of its publications in the nine months ended September 30, 2005 was in line with its strategy.

The Company's revenues for the nine months ended September 30, 2005 increased by 59% from the same period last year. The number of subscribers of the *Travelzoo Top 20* e-mail newsletter increased by 12% for North America. Page views of the homepage of the *Travelzoo* Web site in the U.S. increased by 32% as shown in the table above. In the nine months ended September 30, 2004, 85% of revenues were generated from the *Travelzoo* Web site and the *Travelzoo Top 20* newsletter. In the nine months ended September 30, 2005, 69% of revenues were generated from the *Travelzoo* Web site and the *Travelzoo Top 20* newsletter. Management believes that the data for the nine months ended September 30, 2005 and 2004 indicate that the Company was able to generate higher revenues as reach increased.

Revenues

Our total revenues increased to \$13.4 million for the three months ended September 30, 2005 from \$9.5 million for the three months ended September 30, 2004. Our total revenues increased to \$36.9 million for the nine months ended September 30, 2005 from \$23.2 million for the nine months ended September 30, 2004. This represents an increase of 59%.

Our revenues from operations in the U.K. for the three months ended September 30, 2005, and the period from May 4, 2005 (inception) to September 30, 2005, were approximately \$368,000 and \$378,000, respectively.

67% of our revenue growth in the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 came from our new product, *SuperSearch*. 3% of our revenue growth in the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 came from our operations in the U.K. The remaining 30% came from our other products (i.e. *Travelzoo* Web site in the U.S., *Travelzoo Top 20* newsletter, and *Newsflash*) and is attributed to an increase in our advertising rates for our other products and an increase in the number of clients and the volume of advertising sold. Approximately 23% of the revenue growth in the nine month period ended September 30, 2005 compared to the nine months ended September 30, 2004 is attributed to an increase in our advertising rates for our existing products. Due to the increase in the reach of our publications, we increased the prices for advertising placements on average by approximately 15% as of January 1, 2005. Approximately 7% of our revenue growth in the period ended September 30, 2005 compared to the nine months ended September 30, 2004 is attributed to an increase in the number of clients and an increase in the volume of advertising sold to existing clients.

In the nine months ended September 30, 2005, Click Here, Inc., an advertising agency representing Travelocity.com, accounted for 16% of our total revenues. In the three months ended September 30, 2005, Click Here, Inc. accounted for 12% of our total revenues. In the nine months ended September 30, 2004, Click Here, Inc. accounted for 10% of our total revenues. In the three months ended September 30, 2004, Click Here, Inc. accounted for 15% of our total revenues and Orbitz LLC accounted for 10% of our total revenues. No other clients accounted for 10% or more of our total revenues during the three months and nine months ended September

Table of Contents

30, 2005, and the three months and nine months ended September 30, 2004. The increase in our concentration of revenues is primarily the result of our new *SuperSearch* product. *SuperSearch* listings are primarily purchased by large online travel agencies. There is a high concentration in the online travel agency segment. Management expects revenue concentration to remain at the current level in the foreseeable future.

Management believes that our ability to increase revenues in the future depends mainly on three factors:

- Our ability to increase our advertising rates;
- Our ability to sell more advertising to existing clients; and
- Our ability to increase the number of clients.

We believe that we can increase our advertising rates only if the reach of our publications increases. We do not know if we will be able to increase the reach of our publications. We believe that we can sell more advertising only if the market for online advertising continues to grow and if we can maintain or increase our market share. We believe that the market for online advertising continues to grow. We do not know if we will be able to maintain or increase our market share. We historically increased the number of clients in every year since inception. We do not know if we will be able to increase the number of clients in the future.

Average annualized revenue per employee increased to \$824,000 for the three months ended September 30, 2005 from \$776,000 for the three months ended September 30, 2004.

Cost of Revenues

Cost of revenues consists of network expenses, including fees we pay for co-location services, depreciation of network equipment, salary expenses associated with network operations staff, and fees for photos used in our publications. Our cost of revenues increased to \$225,000 for the three months ended September 30, 2005 from \$184,000 for the three months ended September 30, 2004. Our cost of revenues increased to \$629,000 for the nine months ended September 30, 2005 from \$529,000 for the nine months ended September 30, 2004. As a percentage of revenue, cost of revenues remained the same, 2%, for the nine months ended September 30, 2005 and for the nine months ended September 30, 2004. The increase in cost of revenues in the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was primarily due to an increase in headcount of our network operations staff.

Operating Expenses

Sales and Marketing

Sales and marketing expenses consist primarily of advertising and promotional expenses, salary expenses associated with sales and marketing staff, conference expenses, and public relations expenses. Sales and marketing expenses increased to \$7.1 million for the three months ended September 30, 2005 from \$4.3 million for the three months ended September 30, 2004. Sales and marketing expenses increased to \$18.3 million for the nine months ended September 30, 2005 from \$11.5 million for the nine months ended September 30, 2004. The increase in sales and marketing expenses was primarily due to increases in our advertising campaigns. The goal of our advertising was to acquire new subscribers for our e-mail products and to increase brand awareness for *Travelzoo*. For the nine months ended September 30, 2005 and 2004, advertising expenses accounted for 78% and 76%, respectively, of sales and marketing expenses. Advertising activities during these periods consisted primarily of online advertising. The increase in sales and marketing expenses in the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was also due to an increase in headcount of our sales force.

Our goal is to increase our revenues from advertising sales. One important factor that drives our revenues is our advertising rates. We believe that we can increase our advertising rates only if the reach of our publications increases. In order to increase the reach of our publications, we have to acquire a significant number of new subscribers in every quarter and continue to promote our brand. Therefore, we expect our sales and marketing expenses as a percentage of revenue to remain at the current level or increase from the current level. The main factor that impacts our advertising expenses is the average cost per acquisition of a new subscriber. We believe that the average cost per acquisition depends mainly on the advertising rates which we pay for media buys, our ability to manage our subscriber acquisition efforts successfully, and the degree of competition in our industry.

In May 2005, we began operations in the U.K. The start-up of our business in the U.K. and our plan to expand into other European countries in 2006 is expected to result in a significant additional increase in our sales and marketing expenses in the foreseeable future.

Table of Contents

General and Administrative

General and administrative expenses consist primarily of compensation for administrative and executive staff, fees for professional services, rent, bad debt expense, amortization of intangible assets and general office expense. General and administrative expenses increased to \$1.9 million for the three months ended September 30, 2005 from \$1.7 million for the three months ended September 30, 2004. General and administrative expenses increased to \$6.6 million for the nine months ended September 30, 2005 from \$3.9 million for the nine months ended September 30, 2004. In 2005, general and administrative expenses increased primarily due to expenses of \$1.2 million for cash payments made or to be made to former stockholders of Travelzoo.com Corporation and also due to increases in expenses for legal and professional services related to compliance with Section 404 of the Sarbanes-Oxley Act of 2002.

In the nine months ended September 30, 2005, the Company recorded expenses of \$1.2 million related to a program under which the Company intends to make cash payments to former stockholders of Travelzoo.com Corporation, who failed to submit requests for shares in Travelzoo Inc. within the required time period. The expenses are based on the number of actual valid requests received and the Company's stock price. The Company expects expenses related to the program to decrease in future periods due to an expected decrease in the number of valid requests received.

We expect that we will incur significant expenses in 2005 in order to allow management to report on, and our independent auditors to attest to, our internal controls over financial reporting, as required by Section 404 for the Sarbanes-Oxley Act of 2002. At this time, the total cost is not reliably estimable as it will be dependent on the number of areas requiring improvement and on remediation efforts where necessary. The Company has expensed approximately \$417,000 in third-party compliance costs in the nine months ended September 30, 2005. Currently, none of our identified areas that need improvement have been categorized as material weaknesses or significant deficiencies. However, we are still in the evaluation process, and we may identify conditions that may result in significant deficiencies or material weaknesses in the future.

We expect our headcount to continue to increase in the future. The Company's headcount is one of the main drivers of general and administrative expenses. Therefore, we expect our general and administrative expenses to continue to increase.

We expect the operations of Travelzoo UK to result in a significant additional increase in our general and administrative expenses.

Subscriber Acquisition

The table set forth below provides for each quarter in 2002, 2003, 2004, and the first three quarters of 2005, an analysis of our average cost for acquisition of new subscribers for our *Travelzoo Top 20* newsletter and our *Newsflash* e-mail alert service for our operating segments, North America and Europe.

The table includes the following data:

- **Average Cost per Acquisition of a New Subscriber:** This is the quarterly costs of consumer marketing programs whose purpose was primarily to acquire new subscribers, divided by total new subscribers added during the quarter.
- **New Subscribers:** Total new subscribers who signed up for at least one of our e-mail publications throughout the quarter. This is an unduplicated subscriber number, meaning a subscriber who signed up for two or more of our publications is only counted once.
- **Unsubscribes:** Subscribers who were removed from our list throughout the quarter either as a result of their requesting removal, or based on periodic list maintenance after we determined that the e-mail address was likely no longer valid.
- **Balance:** This is the number of subscribers at the end of the quarter, computed by taking the previous quarter's subscriber balance, adding new subscribers during the current quarter, and subtracting unsubscribes during the current quarter.

Table of Contents

North America:

<u>Period</u>	<u>Average Cost per Acquisition of a New Subscriber</u>	<u>New Subscribers</u>	<u>Unsubscribes</u>	<u>Balance</u>
Q1 2002	\$ 0.93	254,140	(24,547)	1,614,130
Q2 2002	\$ 0.95	590,266	(156,204)	2,048,192
Q3 2002	\$ 1.01	740,656	(51,566)	2,737,282
Q4 2002	\$ 1.31	799,958	(55,064)	3,482,176
Q1 2003	\$ 1.62	693,872	(213,423)	3,962,625
Q2 2003	\$ 1.58	924,902	(172,403)	4,715,124
Q3 2003	\$ 1.52	1,108,045	(248,964)	5,574,205
Q4 2003	\$ 2.17	869,286	(240,907)	6,202,584
Q1 2004	\$ 2.23	920,063	(185,151)	6,937,496
Q2 2004	\$ 2.58	858,899	(634,702)	7,161,693
Q3 2004	\$ 1.26	1,298,962	(602,628)	7,858,027
Q4 2004	\$ 1.70	694,026	(343,139)	8,145,737
Q1 2005	\$ 2.59	659,459	(475,938)	8,329,258
Q2 2005	\$ 2.62	806,734	(533,109)	8,602,883
Q3 2005	\$ 3.19	740,768	(422,868)	8,920,783

Europe:

<u>Period</u>	<u>Average Cost per Acquisition of a New Subscriber</u>	<u>New Subscribers</u>	<u>Unsubscribes</u>	<u>Balance</u>
Q3 2005	\$ 1.65	127,857	(5,577)	140,153

In North America, we have noted a trend of increasing cost per new subscriber over the last few years, driven by a gradual increase in online advertising rates by our media suppliers as well as increased activity from competitors using similar forms of online advertising for their own marketing efforts. The decline in new subscriber acquisition costs in Q3 2004 and Q4 2004 reflects the effect of new advertising campaigns which were tested at that time. We do not consider the decline in new subscriber costs in Q3 2004 and Q4 2004 to be necessarily indicative of a longer-term trend that our subscriber costs are likely to stay at this level or are likely to decline further.

The operational impact of increased acquisition cost is higher absolute marketing expenses and potentially higher relative marketing expenses as a percentage of revenue. Going forward we expect continued upward pressure on online advertising rates and continued activity from competitors, which will likely increase our cost per new subscriber over the long term. The effect on operations is that greater absolute and relative marketing expenditure may be necessary to continue to grow the reach of our publications. It is possible that the factors driving subscriber acquisition cost increases can be partially or completely offset by new or improved methods of subscriber acquisition using techniques which are under evaluation. Thus we are not able to meaningfully predict the short-term quarterly trend in the cost of acquiring new subscribers.

Income Taxes

For the three months ended September 30, 2005, we recorded an income tax provision of \$2.2 million. For the three months ended September 30, 2004, we recorded an income tax provision of \$1.4 million. For the nine months ended September 30, 2005, we recorded an income tax provision of \$5.7 million. For the nine months ended September 30, 2004, we recorded an income tax provision of \$3.0 million. Our income is generally taxed in the U.S. and our income tax provisions reflect federal and state statutory rates applicable to our levels of income and expenses that are treated as having no recognizable tax benefit. For the nine months ended September 30, 2005, our effective tax rate was 47.4%. Expenses of \$1.2 million related to a program under which the Company

Table of Contents

makes cash payments to former stockholders of Travelzoo.com Corporation, who failed to submit requests for shares in Travelzoo Inc. within the required time period, were treated as having no recognizable tax benefit. Further, a loss of \$538,000 from our U.K. operations was treated as having no recognizable tax benefit.

We expect that our effective tax rate in future periods may fluctuate depending on the total amount of expenses representing payments to former stockholders, from losses or gains incurred by our U.K. operations and related U.K. tax liability and corresponding U.S. tax credits, if any.

During the first quarter of 2005, the Company realized a tax benefit of \$396,000 upon the exercise of stock options by a director. The tax benefit reduced the Company's income tax payable and increased additional paid-in capital by this amount.

Stockholders' Equity

In January 2005, an aggregate of 17,275 shares of common stock were issued to a current director upon the exercise of fully vested options. The options were granted in 2001 and 2002 to the director for her services as director in 2000, 2001, and 2002.

Liquidity and Capital Resources

As of September 30, 2005, we had \$42.6 million in cash and cash equivalents and short-term investments. Cash and cash equivalents and short-term investments increased from \$36.5 million on December 31, 2004 primarily as a result of cash provided by operations as explained below. We expect that cash on hand and cash flows generated from operations will be sufficient to provide for working capital needs for at least the next 12 months.

Net cash provided by operating activities in the nine months ended September 30, 2005 was \$6.2 million. Net cash provided by operating activities in the nine months ended September 30, 2004 was \$2.3 million. In the nine months ended September 30, 2005, net cash provided by operating activities resulted primarily from net income and an increase in accrued expenses offset by an increase in accounts receivable. Accounts receivable as a percentage of revenue increased primarily because of a larger portion of insertion orders which include variable-fee advertising, particularly advertising in our *SuperSearch* product. Insertion orders that include variable-fee advertising are invoiced at the end of the month. If revenues from *SuperSearch* continue to increase as a percentage of total revenue, we expect the increase of accounts receivable as a percentage of total revenue to continue. In the nine months ended September 30, 2004, net cash provided by operating activities resulted primarily from net income and tax benefit of stock option exercises offset by an increase in accounts receivable and a net decrease in income tax payable.

Net cash used in investing activities was \$9.7 million and \$39,000 during the nine months ended September 30, 2005 and September 30, 2004, respectively. In the nine months ended September 30, 2005, net cash used in investing activities were for the purchase of short-term investments and for equipment purchases. In the nine months ended September 30, 2004, net cash was used in investing activities for equipment purchases.

Net cash used in financing activities was \$89,000 during the nine months ended September 30, 2005. Net cash provided by financing activities was \$330,000 during the nine months ended September 30, 2004. In the nine months ended September 30, 2005, net cash used in financing activities resulted primarily from registration related expenses incurred during the period related to the issuance of common stock in October 2004. In the nine months ended September 30, 2004, net cash provided by financing activities resulted primarily from proceeds from stock option exercises.

Our capital requirements depend on a number of factors, including market acceptance of our products and services, the amount of our resources we devote to development and launch of new products, cash payments to former stockholders of Travelzoo.com Corporation, expansion of our operations, and the amount of our resources we devote to promoting awareness of the *Travelzoo* brand. Since the inception of the program under which we would make cash payments to persons who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests for our shares within the required time period, we have incurred expenses of \$2.4 million. While future payments for this program are expected to decrease, the total cost of this program is still undeterminable because it is dependent on our stock price and on the number of claims ultimately received. Consistent with our growth, we have experienced a substantial increase in our sales and marketing expenses since inception, and we anticipate that these increases will continue for the foreseeable future. We believe cash on hand and generated during those periods will be sufficient to pay such costs. In addition, we will continue to evaluate possible investments in businesses, products and technologies, the consummation of any of which would increase our capital requirements.

Table of Contents

Although we currently believe that we have sufficient capital resources to meet our anticipated working capital and capital expenditure requirements beyond the next 12 months, unanticipated events and opportunities may require us to sell additional equity or debt securities or establish new credit facilities to raise capital in order to meet our capital requirements. If we sell additional equity or convertible debt securities, the sale could dilute the ownership of our existing stockholders. If we issue debt securities or establish a new credit facility, our fixed obligations could increase, and we may be required to agree to operating covenants that would restrict our operations. We cannot be sure that any such financing will be available in amounts or on terms acceptable to us.

We expect that cash on hand will be sufficient to finance the expected expansion of our European operations.

The following summarizes our principal contractual commitments as of September 30, 2005 (in thousands):

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>Thereafter</u>	<u>Total</u>
Operating leases	\$ 308	570	451	—	—	\$ 1,329
Purchase obligations	29	114	10	—	—	153
Total commitments	<u>\$ 337</u>	<u>684</u>	<u>461</u>	<u>—</u>	<u>—</u>	<u>\$ 1,482</u>

As of September 30, 2005, we have recorded a liability of \$6,000 for the estimated minimum liability that is probable to be paid under a program to make cash payments to former stockholders of Travelzoo.com Corporation. The total liability incurred under this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received.

RISK FACTORS

Investing in our common stock involves a high degree of risk. Any or all of the risks listed below as well as other variables affecting our operating results could have a material adverse effect on our business, our quarterly and annual operating results or financial condition, which could cause the market price of our stock to decline or cause substantial volatility in our stock price, in which event the value of your common stock could decline. You should also keep these risk factors in mind when you read forward-looking statements.

Risks Related to Our Financial Condition and Business Model

Our limited operating history makes our business difficult to evaluate.

We have only a limited operating history for you to consider in evaluating our business. As a young company, we face risks and uncertainties relating to our ability to successfully implement our business plan. You must consider the risks, expenses and uncertainties which can materially affect the business of a young company like ours. These risks include uncertainty whether we will be able to:

- increase awareness of the *Travelzoo* brand;
- attract and retain additional travel companies to list their special offers with us;
- attract additional Internet users to the *Travelzoo* Web sites ;
- attract additional Internet users as subscribers to our e-mail publications ;
- increase the functionality of our products and services;
- maintain our current, and develop new, business relationships;
- respond effectively to competitive pressures; and
- continue to develop and upgrade our technology.

Table of Contents

We cannot assure you that we will sustain profitability.

Although we have been profitable in the past, there is no assurance that we will continue to be profitable. We forecast our future expense levels based on our operating plans and our estimates of future revenues. We may find it necessary to accelerate expenditures relating to our sales and marketing efforts or otherwise increase our financial commitment to creating and maintaining brand awareness among travel companies and Internet users. If our revenues grow at a slower rate than we anticipate, or if our spending levels exceed our expectations or cannot be adjusted to reflect slower revenue growth, we may not generate sufficient revenues to sustain profitability. If our new U.K. operations and our expected expansion into other European countries in 2006 incur significant losses, this will result in a significant negative impact on our results of operations. In this case, the value of the shares of Travelzoo could be reduced.

Fluctuations in our operating results may negatively impact our stock price.

Our quarterly operating results may fluctuate significantly in the future due to a variety of factors that could affect our revenues or our expenses in any particular quarter. You should not rely on quarter-to-quarter comparisons of our results of operations as an indication of future performance. Factors that may affect our quarterly results include:

- mismatches between resource allocation and client demand due to difficulties in predicting client demand in a new market;
- changes in general economic conditions that could affect marketing efforts generally and online marketing efforts in particular;
- the magnitude and timing of marketing initiatives, including our anticipated expansion efforts in Europe during 2006;
- the introduction, development, timing, competitive pricing and market acceptance of our products and services and those of our competitors;
- our ability to attract and retain key personnel;
- our ability to manage our anticipated growth and expansion;
- our ability to attract traffic to our Web sites;
- technical difficulties or system downtime affecting the Internet generally or the operation of our products and services specifically; and
- payments which we make to previous stockholders of Travelzoo.com Corporation who failed to submit requests for shares in Travelzoo Inc. within the required time period.

In addition, we plan to significantly increase our operating expenses related to advertising campaigns for *Travelzoo* and the expansion of our sales and production departments. If revenues fall below our expectations in any quarter and we are unable to quickly reduce our spending in response, our operating results would be lower than expected and our stock price may fall.

We depend on one client for a substantial part of our revenues.

One of our current clients represents a substantial portion of our business. For the nine months ended September 30, 2005, Click Here, Inc., an advertising agency representing Travelocity.com, accounted for 16% of our revenues. In the three months ended September 30, 2005, Click Here, Inc. accounted for 12% of our revenues. The loss of this client may result in a significant decrease in our revenues, which could have a material adverse effect on our business. We have written agreements with Click Here, Inc. The agreements provide that Travelzoo will be paid for the publication of ads on a cost-per-click basis. The Click Here, Inc. agreements are cancelable upon 90 days' written notice, and the payment terms are net 60 days with no discount for early payment. Copies of the agreements with Click Here were previously filed as exhibits to our Annual Report on Form 10-K for the year ended December 31, 2004.

We may incur a material expenses related to a bankruptcy filing from one of our customers that has not yet been expensed.

One of our current clients, Digitas, Inc., represents Delta Air Lines. On September 14, 2005, Delta Air Lines filed for bankruptcy. We are currently unable to determine the effect that this filing will have on our financials. However, the total amount due to us from Digitas, Inc. related to Delta Air Lines is \$194,000. At this time, we are unable to determine how much will be paid to us by Digitas, Inc., thus, we are unable to record a specific reserve for this account. It is possible that we may have to record an expense up to the \$194,000 in future periods because of this bankruptcy filing.

Table of Contents

Our business model is unproven and may not be adaptable to a changing market.

Our current revenue model depends on advertising fees paid by travel companies. If current clients decide not to continue advertising their offers with us and we are unable to replace them with new clients, our business may be adversely affected. To be successful, we must provide online marketing solutions that achieve broad market acceptance by travel companies. In addition, we must attract sufficient Internet users with attractive demographic characteristics to our products. It is possible that we will be required to further adapt our business model in response to changes in the online advertising market or if our current business model is not successful. If we are not able to anticipate changes in the online advertising market or if our business model is not successful, our business could be materially adversely affected.

We may not be able to obtain sufficient funds to grow our business and any additional financing may be on terms adverse to your interests.

We intend to continue to grow our business, and intend to fund our current operations and anticipated growth from the cash flow generated from our operations and our retained earnings. However, these sources may not be sufficient to meet our needs. We may not be able to obtain additional financing on commercially reasonable terms, or at all.

If additional financing is not available when required or is not available on acceptable terms, we may be unable to fund our expansion, successfully promote our brand name, develop or enhance our products and services, take advantage of business opportunities, or respond to competitive pressures, any of which could have a material adverse effect on our business.

If we choose to raise additional funds through the issuance of equity securities, you may experience significant dilution of your ownership interest, and holders of the additional equity securities may have rights senior to those of the holders of our common stock. If we obtain additional financing by issuing debt securities, the terms of these securities could restrict or prevent us from paying dividends and could limit our flexibility in making business decisions.

Our business may be sensitive to recessions.

The demand for online advertising may be linked to the level of economic activity and employment in the U.S. and abroad. Specifically, our business is dependent on the demand for online advertising from travel companies. The last recession decreased consumer travel and caused travel companies to reduce or postpone their marketing spending generally, and their online marketing spending in particular. If the current economic recovery does not continue, our business and financial condition could be materially adversely affected.

Our operations could be significantly hindered by the occurrence of a natural disaster or other catastrophic event.

Our operations are susceptible to outages due to fire, floods, power loss, telecommunications failures, break-ins and similar events. In addition, a significant portion of our network infrastructure is located in Northern California, an area susceptible to earthquakes. We do not have multiple site capacity in the event of any such occurrence. Outages could cause significant interruptions of our service. In addition, despite our implementation of network security measures, our servers are vulnerable to computer viruses, physical and electronic break-ins, and similar disruptions from unauthorized tampering with our computer systems. We do not carry business interruption insurance to compensate us for losses that may occur as a result of any of these events.

Technological or other assaults on our service could harm our business.

We are vulnerable to coordinated attempts to overload our systems with data, resulting in denial or reduction of service to some or all of our users for a period of time. We have experienced denial of service attacks in the past, and may experience such attempts in the future. We do not carry business interruption insurance to compensate us for losses that may occur as a result of any of these events. Any such event could reduce our revenue and harm our operating results and financial condition.

Risks Related to Our Markets and Strategy

We may not be able to develop awareness of our brand name.

We believe that continuing to build awareness of the *Travelzoo* brand name is critical to achieving widespread acceptance of our products. Brand recognition is a key differentiating factor among providers of online advertising opportunities, and we believe it could

Table of Contents

become more important as competition in our industry increases. In order to maintain and build brand awareness, we must succeed in our marketing efforts. If we fail to successfully promote and maintain our brand, incur significant expenses in promoting our brand and fail to generate a corresponding increase in revenue as a result of our branding efforts, or encounter legal obstacles which prevent our continued use of our brand name, our business could be materially adversely affected.

Our business may be sensitive to events affecting the travel industry in general.

Events like the war with Iraq or the terrorist attacks on the U.S. in 2001 have a negative impact on the travel industry. We are not in a position to evaluate the net effect of these circumstances on our business. In the longer term, our business might be negatively affected by financial pressures on the travel industry. However, our business may also benefit if travel companies increase their efforts to promote special offers or other marketing programs. If the events result in a long-term negative impact on the travel industry, such impact could have a material adverse effect on our business.

We will not be able to attract travel companies or Internet users if we do not continually enhance and develop the content and features of our products and services.

To remain competitive, we must continually improve the responsiveness, functionality and features of our products and services. We may not succeed in developing features, functions, products or services that travel companies and Internet users find attractive. This could reduce the number of travel companies and Internet users using our products and materially adversely affect our business.

We may lose business if we fail to keep pace with rapidly changing technologies and clients needs.

Our success is dependent on our ability to develop new and enhanced software, services and related products to meet rapidly evolving technological requirements for online advertising. Our current technology may not meet the future technical requirements of travel companies. Trends that could have a critical impact on our success include:

- rapidly changing technology in online advertising;
- evolving industry standards, including both formal and *de facto* standards relating to online advertising;
- developments and changes relating to the Internet;
- competing products and services that offer increased functionality; and
- changes in travel company and Internet user requirements.

If we are unable to timely and successfully develop and introduce new products and enhancements to existing products in response to our industry's changing technological requirements, our business could be materially adversely affected.

Our business and growth will suffer if we are unable to hire and retain highly skilled personnel.

Our future success depends on our ability to attract, train, motivate and retain highly skilled employees. We may be unable to retain our skilled employees, or attract, assimilate and retain other highly skilled employees in the future. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. If we are unable to hire and retain skilled personnel, our growth may be restricted, which could adversely affect our future success.

We may not be able to effectively manage our expanding operations.

Since the commencement of our operations, we have experienced a period of rapid growth. In order to execute our business plan, we must continue to grow significantly. As of September 30, 2005, we had 65 employees. We expect that the number of our employees will continue to increase for the foreseeable future. This growth has placed, and our anticipated future growth will continue to place, a significant strain on our management, systems and resources. We expect that we will need to continue to improve our financial and managerial controls and reporting systems and procedures. We will also need to continue to expand and maintain close coordination among our sales, production, marketing, IT, and finance departments. We may not succeed in these efforts. Our inability

Table of Contents

to expand our operations in an efficient manner could cause our expenses to grow disproportionately to revenues, our revenues to decline or grow more slowly than expected and otherwise have a material adverse effect on our business.

Our international operations are subject to increased risks which could harm our business, operating results and financial condition.

In May 2005, we began operations in the U.K. Our plan is to expand into other European countries in 2006. In addition to uncertainty about our ability to generate net income from our foreign operations and expand our international market position, there are certain risks inherent in doing business internationally, including:

- trade barriers and changes in trade regulations;
- difficulties in developing, staffing and simultaneously managing foreign operations as a result of distance, language and cultural differences;
- stringent local labor laws and regulations;
- currency exchange rate fluctuations;
- risks related to government regulation; and
- potentially adverse tax consequences.

Intense competition may adversely affect our ability to achieve or maintain market share and operate profitably.

We compete for advertising dollars with large Internet portal sites, such as America Online, MSN and Yahoo!, that offer listings or other advertising opportunities for travel companies. These companies have significantly greater financial, technical, marketing and other resources and larger client bases. We also compete with search engines like Google and Yahoo! Search that offer pay-per-click listings. In addition, we compete with newspapers, magazines and other traditional media companies that provide online advertising opportunities. We expect to face additional competition as other established and emerging companies, including print media companies, enter the online advertising market. Competition could result in reduced margins on our services, loss of market share or less use of *Travelzoo* by travel companies and consumers. If we are not able to compete effectively with current or future competitors as a result of these and other factors, our business could be materially adversely affected.

Loss of any of our key management personnel could negatively impact our business.

Our future success depends to a significant extent on the continued service and coordination of our management team, particularly Ralph Bartel, our Chairman, President, Chief Executive Officer, Chief Financial Officer and Secretary. The loss or departure of any of our officers or key employees could materially adversely affect our ability to implement our business plan. We do not maintain key person life insurance for any member of our management team. In addition, we expect new members to join our management team in the future. These individuals will not previously have worked together and will be required to become integrated into our management team. If our key management personnel are not able to work together effectively or successfully, our business could be materially adversely affected.

We may not be able to access third party technology upon which we depend.

We use technology and software products from third parties including Microsoft. Technology from our current or other vendors may not continue to be available to us on commercially reasonable terms, or at all. Our business will suffer if we are unable to access this technology, to gain access to additional products or to integrate new technology with our existing systems. This could cause delays in our development and introduction of new services and related products or enhancements of existing products until equivalent or replacement technology can be accessed, if available, or developed internally, if feasible. If we experience these delays, our business could be materially adversely affected.

Risks Related to the Market for our Shares

Our stock price has been volatile historically and may continue to be volatile.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. During the first nine months of 2005, the sale prices of our common stock on the NASDAQ National Market ranged from \$21.31 to \$99.75 per share. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements of technological innovations or new products by us or our competitors, changes in financial estimates and recommendations by securities analysts, the operating and stock price performance of other companies that investors may deem comparable to us, and news reports relating to trends in our markets or general economic conditions.

In addition, the stock market in general, and the market prices for Internet-related companies in particular, have experienced volatility that often has been unrelated to the operating performance of such companies. These broad market and industry fluctuations may adversely affect the price of our stock, regardless of our operating performance.

We are controlled by a principal stockholder.

Ralph Bartel, who founded Travelzoo and who is our Chairman of the Board, President, Chief Executive Officer, Chief Financial Officer and Secretary, is our largest stockholder, holding approximately 78% of our outstanding shares with options to increase his percentage ownership to 81% on a fully-diluted basis. Through his share ownership, he is in a position to control Travelzoo and to elect our entire board of directors.

Risks Related to Legal Uncertainty

We may become subject to burdensome government regulations and legal uncertainties affecting the Internet which could adversely affect our business.

To date, governmental regulations have not materially restricted use of the Internet in our markets. However, the legal and regulatory environment that pertains to the Internet is uncertain and may change. Uncertainty and new regulations could increase our costs of doing business, prevent us from delivering our products and services over the Internet or slow the growth of the Internet. In addition to new laws and regulations being adopted, existing laws may be applied to the Internet. New and existing laws may cover issues which include:

- user privacy;
- anti-spam legislation;
- consumer protection;
- copyright, trademark and patent infringement;
- pricing controls;
- characteristics and quality of products and services;
- sales and other taxes; and
- other claims based on the nature and content of Internet materials.

We may be liable as a result of information retrieved from or transmitted over the Internet.

We may be sued for defamation, negligence, copyright or trademark infringement or other legal claims relating to information that is published or made available in our products. These types of claims have been brought, sometimes successfully, against online services in the past. We do not carry professional liability insurance. The fact that we distribute information via e-mail may subject us to potential risks, such as liabilities or claims resulting from unsolicited e-mail or spamming, lost or misdirected messages, security breaches, illegal or fraudulent use of e-mail or interruptions or delays in e-mail service. In addition, we could incur significant costs in

Table of Contents

investigating and defending such claims, even if we ultimately are not liable. If any of these events occur, our business could be materially adversely affected.

Claims may be asserted against us relating to shares not issued in our 2002 merger.

The merger of Travelzoo.com Corporation into the Company became effective on April 25, 2002. Stockholders of Travelzoo.com Corporation were allowed a period of two years following the effective date to receive our shares. After April 25, 2004, two years following the effective date, we ceased issuing shares to the former stockholders of Travelzoo.com Corporation. Many of the “Netsurfer stockholders,” who had applied to receive shares of Travelzoo.com Corporation in 1998 for no cash consideration, did not elect to receive their shares which were issuable in the merger prior to the end of the two-year period. A total of 4,115,532 of our shares which had been reserved for issuance in the merger were not claimed.

It is possible that claims may be asserted against us in the future by former stockholders of Travelzoo.com Corporation seeking to receive our shares, whether based on a claim that the two-year deadline for exchanging their shares was unenforceable or otherwise. In addition, one or more jurisdictions, including the Bahamas or the State of Delaware, may assert rights to unclaimed shares under escheat statutes. If such escheat claims are asserted, we intend to challenge the applicability of escheat rights, among other reasons, in that the identity, residency and eligibility of the holders in question cannot be determined. There were certain conditions applicable to the issuance of shares to the Netsurfer stockholders, including requirements that (i) they be at least 18 years of age, (ii) they be residents of the U.S. or Canada and (iii) they not apply for shares more than once. The Netsurfer stockholders were required to confirm their compliance with these conditions, and were advised that failure to comply could result in cancellation of their shares in Travelzoo.com Corporation. Travelzoo.com Corporation was not able to verify that the applicants met the requirements referred to above at the time of their applications for issuance of shares. If claims are asserted by persons claiming to be former stockholders of Travelzoo.com Corporation, we intend to assert that their rights to receive their shares expired two years following the effective date of the merger, as provided in the merger agreement. We also expect to take the position, if escheat or similar claims are asserted in respect of the unissued shares in the future, that we are not required to issue such shares. Further, even if it were established that unissued shares were subject to escheat claims, we would assert that the claimant must establish that the original Netsurfer stockholders complied with the conditions to issuance of their shares. We are not able to predict the outcome of any future claims which might be asserted relating to the unissued shares. If such claims were asserted, and were fully successful, that could result in us being required to issue up to an additional approximately 4,080,000 shares of common stock for no additional payment, which would result in substantial dilution of the ownership interests of the other stockholders, and in the our earnings per share, which could adversely affect the market price of the common stock.

On October 15, 2004, we announced a program under which we would make cash payments to persons who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests for our shares within the required time period. The accompanying consolidated financial statements include a charge in general and administrative expenses of \$61,000 for these cash payments for the three months ended September 30, 2005 and \$1,191,000 for the nine months ended September 30, 2005 of which \$6,000 remains as a liability as of September 30, 2005. The liability is based on the number of actual requests received from former stockholders through September 30, 2005 for claims which had not yet been processed. The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of our common stock price. Our common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received. We do not know how many of the requests for shares originally received by Travelzoo.com Corporation in 1998 were valid, but we believe that only a portion of such requests were valid. As noted above, in order to receive payment under the program, a person is required to establish that such person validly held shares in Travelzoo.com Corporation. Assuming 100% of the requests from 1998 were valid, former stockholders of Travelzoo.com Corporation holding approximately 4,080,000 shares had not submitted claims under the program as of September 30, 2005.

Our internal controls over financial reporting may not be effective, and our independent auditors may not be able to certify as to their effectiveness, which could have a significant and adverse effect on our business.

We are evaluating our internal controls over financial reporting in order to allow management to report on, and our independent auditors to attest to, our internal controls over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act of 2002 and the rules and regulations of the SEC, which we collectively refer to as Section 404. We are currently performing the system and process evaluation and testing required in an effort to comply with the management assessment and auditor certification requirements of Section 404, which will initially apply to us as of December 31, 2005. In the course of our ongoing Section 404 evaluation, we have identified areas of internal controls that may need improvement. We are still

Table of Contents

in the evaluation process, and we may identify conditions that may result in significant deficiencies or material weaknesses in the future.

We may be unable to protect our registered trademark or other proprietary intellectual property rights.

Our success depends to a significant degree upon the protection of the *Travelzoo* brand name. We rely upon a combination of copyright, trade secret and trademark laws and non-disclosure and other contractual arrangements to protect our intellectual property rights. The steps we have taken to protect our proprietary rights, however, may not be adequate to deter misappropriation of proprietary information.

The U.S. Patent and Trademark Office registered the trademark for “Travelzoo” on January 23, 2001. The European Community registered “Travelzoo” as a Community Trademark on May 11, 2004. If we are unable to protect our rights in the mark, a key element of our strategy of promoting *Travelzoo* as a brand could be disrupted and our business could be adversely affected. We may not be able to detect unauthorized use of our proprietary information or take appropriate steps to enforce our intellectual property rights. In addition, the validity, enforceability and scope of protection of intellectual property in Internet-related industries are uncertain and still evolving. The laws of other countries in which we may market our services in the future are uncertain and may afford little or no effective protection of our intellectual property. The unauthorized reproduction or other misappropriation of our proprietary technology could enable third parties to benefit from our technology and brand name without paying us for them. If this were to occur, our business could be materially adversely affected.

We may face liability from intellectual property litigation that could be costly to prosecute or defend and distract management’s attention with no assurance of success.

We cannot be certain that our products, content and brand names do not or will not infringe valid patents, copyrights or other intellectual property rights held by third parties. We may be subject to legal proceedings and claims from time to time relating to the intellectual property of others in the ordinary course of our business. We may incur substantial expenses in defending against these third party infringement claims, regardless of their merit, and such claims could result in a significant diversion of the efforts of our management personnel. Successful infringement claims against us may result in monetary liability or a material disruption in the conduct of our business.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We believe that our potential exposure to changes in market interest rates is not material. The Company has no outstanding debt and is not a party to any derivatives transactions. We invest in highly liquid investments with short maturities. Accordingly, we do not expect any material loss from these investments.

Our U.K. operations expose us to foreign currency risk associated with agreements being denominated in British Sterling Pounds and Euros. Further, we are exposed to foreign currency risk associated with fluctuations of the British Sterling Pounds as the financial position and operating results of our U.K. subsidiary will be translated into U.S. Dollars for consolidation purposes.

Item 4. Controls and Procedures

As of September 30, 2005, we carried out an evaluation, under the supervision and with the participation of the Company’s management, including the Company’s President, Chief Executive Officer and Chief Financial Officer along with the Company’s Controller (Chief Accounting Officer), of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Company’s President, Chief Executive Officer and Chief Financial Officer along with the Company’s Controller (Chief Accounting Officer) concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in our periodic SEC filings as of September 30, 2005.

During the quarter ended September 30, 2005, there was no change in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) that materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

Table of Contents

PART II—OTHER INFORMATION

Item 6. *Exhibits*

The following table sets forth a list of exhibits:

Exhibit Number	Description
3.1	Certificate of Incorporation of Travelzoo Inc. (Incorporated by reference to our Pre-Effective Amendment No. 6 to our Registration Statement on Form S-4 (File No. 333-55026), filed February 14, 2002)
3.2	By-laws of Travelzoo Inc. (Incorporated by reference to our Pre-Effective Amendment No. 6 to our Registration Statement on Form S-4 (File No. 333-55026), filed February 14, 2002)
31.1*	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended
32.1*	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith

SIGNATURES

Pursuant to the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of New York, State of New York, on November 11, 2005.

TRAVELZOO INC.
(Registrant)

By: _____ /s/ RALPH BARTEL
Ralph Bartel
*Chairman of the Board,
Chief Executive Officer, and
Chief Financial Officer*

By: _____ /s/ LISA SU
Lisa Su
Controller (Chief Accounting Officer)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Ralph Bartel, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Travelzoo Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:

a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this quarterly report based on such evaluations; and

c. disclosed in this report any change in the registrants' internal control over financial reporting that occurred during the registrants' third quarter that has materially affected, or is reasonably likely to materially affect, the registrants' internal control over financial reporting;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a. all significant deficiencies in the design or operation of internal control over financial reporting which affect the registrant's ability to record, process, summarize and report financial information; and

b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

TRAVELZOO INC.

By: _____ /s/ RALPH BARTEL
Ralph Bartel
*Chairman of the Board,
Chief Executive Officer, and
Chief Financial Officer*

Date: November 11, 2005

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized and each of the undersigned hereby certifies, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, to the best of his knowledge, that (1) this Report complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 and (2) the information contained in this report fairly presents, in all material respects, the financial condition and results of operations of the registrant.

TRAVELZOO INC.
(Registrant)

Date: November 11, 2005

By: _____ /s/ RALPH BARTEL
Ralph Bartel
*Chairman of the Board,
Chief Executive Officer, and
Chief Financial Officer*

End of Filing

Powered By **EDGAR**
Online

© 2005 | EDGAR Online, Inc.